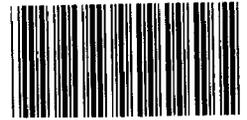




COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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RELEASED

May 3, 1983

The Honorable William V. Roth, Jr.
Chairman, Committee on Governmental
Affairs
United States Senate

Dear Mr. Chairman:

Subject: Comptroller General's Views on Issues Related to the Reestablishment of the Cost Accounting Standards Board Function and Certain Matters on CAS 408, "Accounting for Costs of Compensated Personal Absence" (GAO/PLRD-83-75)

In your letter of April 18, 1983, you requested GAO's views on questions regarding the Cost Accounting Standards Board (Board) function and our opinion on certain aspects relating to Cost Accounting Standards (CAS) 408, "Accounting for Costs of Compensated Personal Absence." GAO's opinions on the CAS 408 questions are included in Enclosure I.

This letter discusses the Cost Accounting Standards Board, the operation of the Standards since the Board ceased operation on September 30, 1980, and GAO's views on the two questions you have asked on the Board's function.

BACKGROUND ON THE COST ACCOUNTING STANDARDS BOARD FUNCTION

In the Summer of 1970 the Congress passed and the President signed into law an amendment to the Defense Production Act of 1950. This act, P.L. 91-379, established the Cost Accounting Standards Board as an agent of the Congress, independent of the executive departments. The Board was established to promulgate cost accounting standards which were designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors under Federal contracts.

During its 10-year life, the Board promulgated 19 standards. They are grouped in three general categories (1) overall cost accounting matters; (2) classes, categories, and elements of cost; and (3) pools of indirect cost.

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The Board became inactive on September 30, 1980, due to the lack of a fiscal year 1981 appropriation. In the several months prior to the Board becoming inactive and, for several months after, there were extensive discussions about the need for and desirability of continuing the Board's function. Efforts to continue the Board failed and it ceased operations at the close of fiscal year 1980.

Concerned that the absence of an active Board function could have a negative impact on the Standards and their implementation and administration, then Comptroller General, Elmer B. Staats, sent a letter to the heads of affected procurement agencies on October 3, 1980, alerting them to the fact that while the Board may be inactive, the Standards promulgated by the Board continue to have the full force and effect of law. Copies of the letter also were sent to appropriate members of Congress. To assure that the Board files would be preserved, GAO assumed custody of such files until such time as the function was reactivated. Additionally, a small CAS monitoring group was established in the General Accounting Office to carry out its oversight role in this important procurement area. GAO's oversight role is carried out under the authority contained in its own legislation.

GAO VIEWS ON THE COST ACCOUNTING STANDARDS BOARD FUNCTION

You requested our views on (1) the desirability of reestablishing the Board function and (2) the appropriate location in the government of such a function if a need for it does exist.

1. Need for Reestablishing the Board's Function

The GAO, through its oversight role of government procurement operations, has conducted reviews of the implementation of the Standards and the Defense Contract Audit Agency's (DCAA's) role in monitoring contractor compliance with the Standards. Currently, GAO has several ongoing assignments dealing specifically with selected standards. While GAO's work to date has shown that Federal departments and agencies implementation of the Standards is generally good and DCAA's CAS compliance determinations appear reasonable, GAO believes that, with the passage of time, the need to reactivate some form of a Board function increases. It appears increasingly more difficult for contractors, agency officials, and those charged with resolving CAS related disputes to continue to operate efficiently without the aid and benefit of a Board. The environment in which the Standards exist continues to change while the Standards themselves remain fixed. In essence, GAO believes that the lack of a Board is inhibiting the effectiveness of the Standards. Our belief is predicated on numerous problems which would be either resolved or dramatically improved if a Board were in operation. Some examples of these problems which have arisen since the Board ceased to operate are discussed briefly below.

--Without a Board there is one empowered to grant waivers and exemptions to the Standards; yet it was the apparent

intent of Congress in the authorizing legislation to have a body to consider the need for waivers and exemptions. Recently the National Aeronautics and Space Administration (NASA) and a subcontractor negotiated for over 2 years on the issue of providing a waiver to CAS. Finally, NASA used authority under P.L. 85-804 to grant relief from CAS coverage to the subcontractor.

--From time to time during the Board's life, it felt the need to provide interpretations of the Standards when there was a widespread and serious question of the Board's intended meaning. Currently, such a question exists around the intended use of a special provision of CAS 409 "Depreciation of Tangible Capital Assets". DOD recently issued a memo to its procurement officials encouraging the use of this special provision. The GAO is concerned that this memo may focus undue attention and emphasis on what is essentially an exception provision of the Standard. The circumstances which warrant the use of this special provision is a question that a CAS Board may wish to review. Without a Board, formal action on CAS 409 is not possible.

--The Board had issues under consideration for possible future Standards when it ceased operation in 1980. These issues included:

- Allocation of Selling & Marketing Expenses
- Joint Product Costing
- Capital Asset - Gain on Disposition

--One significant role that the Board had set for itself was the evaluation of the Standards in operation. That effort had just begun when the Board's funding expired.

For these reasons and others that will arise in connection with the dynamics of accounting for defense contracts, GAO believes that a body of work exists that is significant enough to warrant the reactivation of a Board.

2. Appropriate Location for the Board Function

In expressing our views on the appropriate location for a reactivated Board, two features should be discussed:

1. The Standards are founded in well-reasoned accounting theory. The Board and its staff put extensive effort into researching, drafting, soliciting comments, and revising drafts of the Standards. The Board discussed at length the proposed Standards and was not satisfied until it had heard the salient arguments for or against the Standards. As a testament to their work, it should be noted that none of the 19 Standards was rejected during the 60 day period that each was required by law to

lay before the Congress. In all their efforts, the Board and its staff strove to maintain and promote good accounting in an effort to increase uniformity and consistency in accounting for costs on defense contracts. This devotion to sound accounting was a paramount consideration to the Board and staff. GAO considers it imperative that any continuing Board function be given sufficient accounting expertise and experience to maintain the cost accounting integrity of the promulgated Standards.

2. The second critical feature which must be addressed is independence of this cost accounting activity from the economic and incentive factors which influence Federal procurement policy. These factors can range from the unallowability of certain cost elements to maintaining the industrial base. This independence was one of the primary features sought by the Congress in authorizing the Board under P.L. 91-379 which provided that the Board be an agent of the Congress and independent from the executive branch. For the first time since the Armed Services Procurement Act of 1947, determinations as to the proper methods for measurement and allocation of cost were established by accountants who were independent of the Federal procurement process. GAO believes that this independence was intended by the Congress and that the same independence should be maintained in any continuing Board function.

GAO believes, therefore, that any Congressional action on the location of the Board function must ensure the availability of adequate accounting expertise and independence. There are two options for location which, if chosen, would in the opinion of GAO satisfy the criteria discussed above:

The option preferred by GAO would be for the Congress to appropriate a limited amount of funds to the original authorizing legislation, P.L. 91-379. The necessary funds would cover the compensation and travel of the Board members appointed from private life as prescribed in P.L. 91-379. GAO with some augmentation of its staff, would provide the primary staff support for the Board. This action would revitalize the Board and satisfy the criteria for independence and the availability of accounting expertise. Also, this option would satisfy one of the House Appropriations Committee's concern when it denied the Board's fiscal 1981 budget request. Reactivating the Board and placing the staff support role, at a reduced level in GAO, would provide for a continuing function to be maintained at reduced costs to the Federal Government.

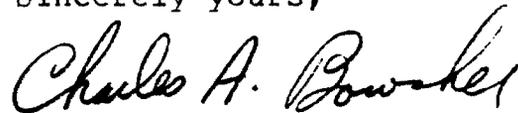
A secondary option is to issue new authorizing legislation to empower the Comptroller General as the head of GAO to perform all duties and functions that belonged to the Board. Provisions could be made for an Advisory Board similar to the prior Board's

make-up which would advise the Comptroller General of the affected parties' views. GAO with some augmentation of its staff would perform the support duties. As with the previous option, reactivating the Board function would be accomplished, while ensuring independence and providing accounting expertise at a reduced cost to the Federal Government.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time we will send copies to interested parties and make copies available to others upon request.

GAO stands ready to assist the Congress in its deliberations on matters involving the Cost Accounting Standards Board function. If we can be of further assistance please let us know.

Sincerely yours,

A handwritten signature in cursive script that reads "Charles A. Bowsher".

Comptroller General
of the United States

Enclosure

GAO RESPONSES TO QUESTIONS REGARDING COST ACCOUNTING STANDARD 408
"ACCOUNTING FOR COSTS OF COMPENSATED PERSONAL ABSENCE"

Question No. 1: Do you concur with the above assessment of accrued vacation expenses? If not, provide the Committee with the rationale for nonconcurrence.

Because the accrued vacation expense described in your statement of the problem is first measured and allocated in accordance with CAS 408 and then reimbursed pursuant to DOD procurement regulations, GAO cannot view such reimbursement as premature. The underlying issues raised by your interest are that of reasonableness and equity. Is it reasonable or equitable for contractors to be reimbursed in advance of their payment to employees for their earned vacation? GAO believes the question of fairness and equity can best be addressed after more is known about the extent and magnitude of the problem. Once the problem has been clearly defined then an assessment of proposed solutions designed to provide greater reasonableness and equity can be assessed.

You stated that, "At the present time, Cost Accounting Standards applicable to Department of Defense contracts require that accrued vacation expenses be assigned to the year the employee earned the rights to such vacation even though they may not take and be paid for such vacation until some subsequent year". A review of the Board files on this subject confirms that it was the intent of the Board to eliminate what it saw as inconsistencies in the accounting treatment of this element of costs and to establish the accrual method of accounting as the acceptable method for accounting for the costs of compensated personal absence of employees performing on Government contracts. In the prefatory comments to CAS 408 the Board recognized that the costs of compensated personal absence are an important element of labor costs, but under existing procurement regulations there is no assurance that the costs of compensated personal absence are assigned to the cost accounting period in which the related labor is performed and in which the related wage or salary costs are recognized. Because the volume and mix of Government and non-Government contracts of a particular contractor may vary significantly from period to period, the assignment of the cost to the proper cost accounting period is important. DOD policies, with regard to the timing of the reimbursement, call for the appropriately measured and allocated (under CAS 408) accrued vacation expense to be reimbursed, as an incurred cost, when the accrual is made. We believe you have correctly interpreted the Standard and DOD reimbursement policies. Since the amount of the accrual is determined in accordance with the Standard and paid as an accrual pursuant to DOD policy, we cannot call this reimbursement premature.

Our research on this matter has included review of the Board files on CAS 408, contact with former staff members of the Board and examination of procurement regulations and policies. In conducting the background research on the issue of accounting for vacation pay, the staff of the Board reviewed numerous Defense contractor plans. They found virtually none that permitted unlimited accrual and the overwhelming majority of plans had an accrual period of less than or equal to one year. The issue of an extended period (greater than 12 months) between the accrual and liquidation of the accrual (actually taking the leave) did not surface as a problem during the research and drafting of the Standard. As mentioned in the body of this letter, the procurement and contracting environment is subject to continual change. It has been almost 8 years since the Standard became effective and over 10 years since the research was first initiated on the subject. The procurement environment has changed and it is possible that new issues related to vacation pay expense may have surfaced. If so, this points again to the need for a continuing Board function to ensure that the intended purpose and effect of the Standards continue to be fulfilled.

Question No. 2: Do you concur with the proposed corrective action? (i.e., amendment of the various payment clauses) If not, provide the Committee with the rationale for nonconcurrence.

The proposed corrective action i.e., "amendment of the various payment clauses" set forth in the attachment to your letter presumes that current DOD payment of accrued vacation expense is a problem. Our review of the Board files on CAS 408 has not surfaced evidence that would suggest that extensive time lags (greater than 12 months) were anticipated between accrual and subsequent liquidation. As stated in our response to the first question, GAO believes that the extent of the problem you pose is not yet been fully developed. Before any corrective action is taken, the problem should be studied to (1) determine the extent and significance of the problem, (2) identify possible solutions once the magnitude of the problem is known and (3) evaluate the anticipated effectiveness of the proposed solution.

Preliminary discussions with accountants in both industry and government indicate that significant cost accounting and administrative problems could arise if the suggested solution were to be implemented. Some accountants suggested that the individual nature of vacations would create a significant administrative problem if the payment clauses were amended to require contractors to pay vacation expense before being reimbursed. GAO believes that, before any change is made, appropriate study of the problem, proposed solutions, and their impact on contractor's compliance with CAS 408 must be conducted.

If it is shown that problems have arisen which, because of changed circumstances the Board did not address at the time of CAS 408's promulgation, then this is another reason which suggests the need for a continuing Board function.